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No.

Supreme Court, U.S.
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In The

Supreme Court of the United States

October Term, 1992

KERRY W. ILLES,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Petition for Writ of Certiorari to the United States Court of Appeals for the Sixth Circuit

PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Whether the decision of the Sixth Circuit Court of Appeals in this case conflicts with the decisions of the Second and Tenth Circuit Courts of Appeals which recognize a facts and circumstances test for determining whether a taxpayer entered a transaction for the purpose of earning a profit?

2. Whether the decision of the Sixth Circuit Court of Appeals in this case conflicts with the decision of this Court rendered in *United States v. Boyle*, 469 U.S. 241 (1985), wherein it was recognized that a taxpayer could rely on the advice of an accountant or attorney and not be required to seek a second opinion?

3. Whether the decision of the Sixth Circuit Court of Appeals in this case conflicts with the decisions of the Fifth and Ninth Circuit Courts of Appeals which refuse to impose penalties for valuation overstatements of assets where the valuation overstatements are found to be irrelevant to the determination of any tax due?

4. Whether the decision of the Sixth Circuit Court of Appeals in this case conflicts with the decisions of the Fifth and Ninth Circuit Courts of Appeals which refuse to impose penalties for substantial understatement of income taxes where the taxpaper relies in good faith upon the investment advice of his or her accountant?

5. Whether the decision of the Sixth Circuit Court of Appeals in this case conflicts with the decision of the Fifth Circuit Court of Appeals in *Heasley v. Commissioner*, 902 F.2d 380 (5th Cir. 1990), regarding the imposition of the tax motivated interest penalty and its application to transactions entered into for profit?

LIST OF PARTIES

A. Petitioner-Appellant Kerry W. Illes.

B. Respondent-Appellee Commissioner of Internal Revenue.

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vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Petition for Writ of Certiorari to the United States Court of Appeals for the Sixth Circuit

PETITION FOR WRIT OF CERTIORARI

OPINIONS BELOW

A. *Kerry W. Illes v. Commissioner of Internal Revenue,* CA No. 91-2412 (6th Cir., September 21, 1992) (Appendix, p. la, *et seq.*).

B. *Kerry W. Illes v. Commissioner of Internal Revenue,* 62 T.C.M. (CCH) 728 (1991) (Appendix, p. 13a, *et seq.*).

STATEMENT OF JURISDICTION

Judgment was entered on September 21, 1992. Jurisdiction in this Court is invoked under the provisions of 28 U.S.C. § 1254.

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

A. 26 U.S.C. § 165 [1954 Code]:

> (a) GENERAL RULE. – There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.
>
> (c) LIMITATION ON LOSSES OF INDIVIDUALS — In the case of an individual, the deduction under subsection (a) shall be limited to –
>
> > (2) losses incurred in any transaction entered into for profit, though not connected with a trade or business;

B. 26 U.S.C. § 6621(c) [1954 Code] (Repealed, P.L. 101-239):

> (1) In general - In the case of interest payable under section 6601 with respect to any substantial underpayment attributable to tax motivated transactions, the rate of interest established under this section shall be 120 percent of the underpayment rate established under this section.

(3) Tax motivated transactions.–

(A) In general - For purposes of this subsection, the term "tax motivated transaction" means —

(i) any valuation overstatement (within the meaning of section 6659(c))

. . .

(v) any sham or fraudulent transaction.

C. 26 U.S.C. § 6653 [1954 Code]:

(a) NEGLIGENCE OR INTENTIONAL DISREGARD OF RULES AND REGULATIONS WITH RESPECT TO INCOME, GIFT, OR WINDFALL PROFIT TAXES.–

(1) IN GENERAL - If any part of any underpayment (as defined in subsection (c)(l)) of any tax imposed by subtitle A, by chapter 12 of subtitle B or by chapter 45 (relating to windfall profit tax) is due to negligence or intentional disregard of rules or regulations (but without intent to defraud), there shall be added to the tax an amount equal to 5 percent of the underpayment.

(2) ADDITIONAL AMOUNT FOR PORTION ATTRIBUTABLE TO NEGLIGENCE, ETC. – There shall be

added to the tax (in addition to the amount determined under paragraph (1)) an amount equal to 50 percent of the interest payable under section 6601 –

(A) with respect to the portion of the underpayment described in paragraph (1) which is attributable to the negligence or intentional disregard referred to in paragraph (1), and

(B) for the period beginning on the last date prescribed by law for payment of such underpayment (determined without regard to any extension) and ending on the date of the assessment of the tax (or, if earlier, the date of the payment of the tax).

D. 26 U.S.C. § 6659 [1954 Code] (Repealed, P.L. 101-239):

(a) ADDITION TO THE TAX - IF -

(1) an individual, or

(2) a closely held corporation or a personal service corporation, has an underpayment of the tax imposed by chapter 1 for the taxable year which is attributable to a valuation overstatement, then there shall be added to the tax an amount equal to the applicable percentage of the underpayment so attributable.

E. 26 U.S.C. § 6661 [1954 Code] (Repealed, P.L. 101-239):

> (a) ADDITION TO TAX – If there is a substantial understatement of income tax for any taxable year, there shall be added to the tax an amount equal to 25 percent of the amount of any underpayment attributable to such understatement.

STATEMENT OF THE CASE

This case arises from a decision of the Sixth Circuit Court of Appeals affirming the Tax Court, which opinion was filed September 21, 1992. The Sixth Circuit Court of Appeals held that:

(1) The Commissioner properly disallowed the claimed section 165(c)(2) deduction, regardless of whether Petitioner Kerry W. Illes was actually, honestly, and exclusively motivated by profit because Kerry W. Illes had previously stipulated that the Cassette transaction lacked economic substance;

(2) The Commissioner properly imposed the negligence penalty under section 6653(a) because Petitioner Kerry W. Illes offered no proof that he ever investigated the investment or sought independent professional advice on the validity and viability of the investment;

(3) The tax benefit generated by the Cassette transaction was directly dependent upon the valuation overstatement, and the amount of the tax benefit was actually determined by the amount of the overvaluation. Kerry W. Illes's underpayment, therefore, was attributable to his valuation overstatement;

(4) The Commissioner's assertion of the addition to tax under section 6661 herein was proper because Petitioner Kerry W. Illes

did not reasonably and in good faith rely on the advice of his accountant;

(5) The increased interest asserted under section 6621(c) was properly computed because the additions to tax determined under sections 6659 and 6661 were found to be applicable.

In 1981, Structured Shelters, Inc. marketed an investment entitled Children's Classic Series. The promotion involved the leasing of master recordings of children's stories for the purpose of producing record albums. Structured Shelters, Inc. used salesmen, commonly referred to as "chartered representatives," to market several different tax-advantaged investments. Thomas A. Graham was a chartered representative of Structured Shelters, Inc.

Kerry W. Illes was approached by Mr. Graham in March, 1984, after telephoning him concerning preparation of architectural designs for two office buildings. During a meeting regarding this project, Mr. Illes met with Graham & Associates, Graham's financial advisory firm, who advised him to consider entering some of their programs. It was in December, 1985, when the Children's Classic Series (Cassettes) investment was presented to him (R12: K. Illes at T.R. 5-6).

In December of 1985 Mr . Illes entered into an agreement to purchase for $115,000 the rights for the limited use of the artwork and the title from the story of "Renowned Bedtime Stories" for the production of a master recording. Mr. Illes made a down payment of $25,000, with the balance of $90,000 due in five years. Kerry Illes also entered into an advertising agreement with Marketing Complex, Inc. for $8,000, of which $2,000 was paid in cash. Mr. Illes executed a promissory note in the amount of $6, 000, payabl e from future sales of cassette tapes, with any balance remaining payable in five years.

In addition and also in December, 1985, Mr. Illes entered into an agreement to lease a master recording entitled "Jokes and Riddles" to produce cassette tapes. Kerry Illes agreed to an advance rental payment of $16,700, of which $4,175 was paid in cash and the balance was due in five years. Mr. Illes entered into a second advertising agreement with Marketing Complex, Inc. for $8,000 of which $2,000 was paid in cash . The balance was payable as mentioned above.

Kerry W. Illes anticipated that his investment in Cassettes would return a relatively quick profit. He based this anticipation on representations made by Graham & Associates, who stated that the Cassette investment was a good vehicle for funding a retirement plan, as well as, for earning substantial income.

After Mr. Illes invested in the Cassette promotion, he relied on Graham & Associates for all advice, ranging from investment counselling to preparation of tax returns. He relied upon this advice because he was not capable of personally understanding investment fundamentals, the preparation of his tax return, or for that matter, what schedule C of Form 1040 actually was (R12: K. Illes at T.R. 9-11) .

Kerry W. Illes has a bachelor's degree in architecture from Ohio University. At no time has he received any formal or informal training in financial planning, accounting or tax return preparation. Mr. Illes has never prepared his own tax return. Prior to being solicited by Graham & Associates, all documentation concerning Mr. Illes' architectural business was submitted to Graham, who completed Mr. Illes' tax returns using their own figures derived from the cassette investment (R12: K . Illes at T.R. 5, 6, 9 and 10).

In 1986 Mr. Illes became concerned about his Cassette investment made with Graham & Associates. He tried to contact Mr. Graham at various times during the year, but received no

response. Because he became suspicious, Mr. Illes sought the advice of another Certified Public Accountant, who subsequently decided Mr. Illes should no longer be involved with Graham & Associates (R12: K. Illes at T.R. 10 and 24).

Kerry W. Illes has no understanding of how his investments, or his architectural business operate. He relied upon a professional for tax, accounting, and investment advice prior to investing with Graham & Associates. He thought he was relying on a professional in Thomas A. Graham. Since 1986 Mr. Illes has relied on another professional (R12: K. Illes at T.R. 12, 13 and 24).

Kerry W. Illes admits in hindsight that the Cassette promotion was a sham and fraudulent transaction. However, at the time he invested with Graham & Associates, Mr. Illes expected to receive a substantial return on his investment. Mr. Illes was not even aware that tax benefits were part of the transaction. Only now does he realize what actually took place (R12: K. Illes at T.R. 9, 11 and 17).

BASIS FOR FEDERAL JURISDICTION IN THE TAX COURT

26 U.S.C. §§ 6213 and 7442.

REASONS FOR GRANTING THE WRIT

I.

THE DECISION OF THE SIXTH CIRCUIT COURT OF APPEALS IN THIS CASE CONFLICTS WITH THE DECISIONS OF THE SECOND AND TENTH CIRCUIT COURTS OF APPEALS WHICH RECOGNIZE A FACTS AND CIRCUMSTANCES TEST FOR DETERMINING WHETHER A TAXPAYER ENTERED A TRANSACTION FOR THE PURPOSE OF EARNING A PROFIT.

Internal Revenue Code Section 165 allows losses sustained during a taxable year and not compensated for by insurance, or otherwise if incurred in any transaction entered into for profit, though not connected with a trade or business. A loss shall be treated as "sustained," within the meaning of 26 U.S.C. § 165, in the year in which the loss occurs, as evidenced by closed and completed transactions and as fixed by identifiable events. Treas. Reg. Sec. 1.165-1(d)(1).

The question of whether a taxpayer has participated in a transaction with the requisite intent to earn a profit and, hence, entitled to a section 165(c)(2) deduction if the transaction fails, has been visited by various Circuit Courts of Appeals other than the Sixth Circuit Court of Appeals. These courts have utilized substantially consistent approaches with regard to this issue, and have determined that what need be shown is that the taxpayer entered into the transaction in good faith, for the purpose of making a profit at the time of entering into the transaction.

In the case of *Jacobson v. Commissioner of Internal Revenue*, 915 F.2d 832 (2nd Cir. 1990) the Second Circuit Court of Appeals held that although a reasonable expectation of profit is not required, the facts and circumstances must indicate that the taxpayer entered into the activity, or continued the activity, with the objective of making a profit. In so holding, the Second Circuit

Court of Appeals ruled that in determining whether an activity is engaged in for profit, greater weight is given to objective facts than to the taxpayer's mere statement of his intent.

Similarly, in a case concerning commodity futures trading, the Tenth Circuit Court of Appeals held that the test of deductibility is one of degree, considering the facts and circumstances surrounding the transaction. *Miller v. Commissioner of Internal Revenue*, 836 F.2d 1274 (10th Cir. 1988). Indeed, as pointed out by the court in *Miller*, when there is no intended profit and naturally could be none, there is no just demand for a deduction of a loss.

In this case the Tax Court found that regardless of whether Mr. Illes entered into the Cassette investment for profit or not, the loss deduction was disallowed because the transactions involved lacked economic substance. In citing *Mahoney v. Commissioner*, 808 F.2d 1219 (6th Cir. 1987), the Tax Court held that if a transaction is a complete sham, then such niceties as whether the test (for whether a transaction is "entered into for profit") is an objective one or subjective one are simply not involved.

On appeal the Sixth Circuit Court of Appeals avoided the facts and circumstances analysis suggested by the Second and Tenth Circuit Courts of Appeals and, instead, focused on the stipulation made by Mr. Illes that, in hindsight, the Cassette investment was a sham transaction with no economic substance. The Sixth Circuit Court of Appeals found that because Illes stipulated that the transaction lacked economic substance, whether he entered the investment motivated by profit was completely irrelevant.

The conflict between *Jacobson*, *Miller* and the Sixth Circuit's decision in this case is especially troubling since it suggests hindsight analysis for all investment transactions, whether motivated by profit or not.

In summary, the test for determining whether a transaction is

entered into for profit should be based on the facts and circumstances of each case. Kerry W. Illes entered into the Cassette transaction with the requisite intent to earn a profit. Through hindsight analysis it was agreed that the transaction lacked economic substance. The Sixth Circuit's ruling in this case is in error as it fails to recognize the breadth of its test. Accordingly, this Court should exercise its discretion to resolve this conflict between the Circuits and reverse the Circuit Court of Appeals decision in this case.

II.

THE DECISION OF THE SIXTH CIRCUIT COURT OF APPEALS IN THIS CASE CONFLICTS WITH THE DECISION OF THIS COURT RENDERED IN *UNITED STATES v. BOYLE,* 469 U.S. 241 (1985), WHEREIN IT WAS RECOGNIZED THAT A TAXPAYER COULD RELY ON THE ADVICE OF AN ACCOUNTANT OR ATTORNEY AND NOT BE REQUIRED TO SEEK A SECOND OPINION.

For the purposes of Internal Revenue Code Section 6653, negligence is the lack of due care or the failure to do what a reasonably prudent person would do under the circumstances.

This Court held in *United States v. Boyle,* 469 U.S. 241 (1985), that when an accountant or attorney advises a taxpayer on a matter of tax law, such as whether a liability exists, it is reasonable for the taxpayer to rely on that advice. Most taxpayers are not competent to discern error in the substantive advice of an accountant or attorney.

In this case the Tax Court found that Mr. Illes' asserted reliance on his accountant in no way could be viewed as reasonable. The Tax Court stated that the minimum standard of performance would require an independent investigation of the investment together with retention of additional advisors.

On appeal the Sixth Circuit Court of Appeals agreed with the findings of the Tax Court and concluded that because Thomas A. Graham was not a disinterested source, Kerry W. Illes' reliance could not be found to be reasonable. The Sixth Circuit's holding is inapposite to this Court's decision in *United States v. Boyle*, 469 U.S. 241 (1985). This Court stated therein that to require the taxpayer to challenge the attorney, to seek a "second opinion" or to try to monitor counsel on the provisions of the Code himself would nullify the very purpose of seeking the advice of a presumed expert in the first place, 469 U.S. at 251.

The conflict between *Boyle* and the Sixth Circuit's decision is particularly disturbing given that Mr. Illes lacks any understanding of the tax consequences of the investment.

In summary, Mr. Illes' reasonable reliance on his accountant herein should be adequate to waive the asserted negligence penalty. The standard enunciated by the Sixth Circuit regarding independent investigation of the transaction is directly contrary to this Court's holding in *Boyle*. Accordingly, this Court should exercise its discretion to resolve this conflict between the Sixth Circuit Court of Appeals and this Court and reverse the Circuit Court of Appeals decision in this case.

III.

THE DECISION OF THE SIXTH CIRCUIT COURT OF APPEALS IN THIS CASE CONFLICTS WITH THE DECISIONS OF THE FIFTH AND NINTH CIRCUIT COURTS OF APPEALS WHICH REFUSE TO IMPOSE PENALTIES FOR VALUATION OVERSTATEMENTS OF ASSETS WHERE THE VALUATION OVERSTATEMENTS ARE FOUND TO BE IRRELEVANT TO THE DETERMINATION OF ANY TAX DUE.

Internal Revenue Code Section 6659 is an addition to tax for claiming valuation overstatements. Kerry W. Illes admits that the

value ascribed to his interest in the Cassette assets exceeded their real value, but he submits that his underpayment is the result of claiming an improper deduction, rather than a valuation overstatement.

The applicability of the addition to tax under Internal Revenue Code Section 6659 has been examined by several Circuit Courts of Appeals other than the Sixth Circuit. The Fifth and Ninth Circuit Courts of Appeals have interpreted the phrase "attributable to" a valuation overstatement in a much different light than the Second and Eighth Circuit Courts of Appeals.

In *Heasley v. Commissioner of Internal Revenue*, 902 F.2d 380 (5th Cir. 1990) and *Todd v. Commissioner of Internal Revenue*, 862 F.2d 540 (5th Cir. 1988), the Fifth Circuit Court of Appeals held that upon comparison of the taxpayers' actual tax liability (without the improperly claimed deductions and credits) with their claimed liability, if the liability is the same, then the valuation overstatement did not contribute to an underpayment of tax. The Fifth Circuit stated that if the Service completely disallows a deduction or credit, it may not penalize the taxpayer for a valuation overstatement included in the deduction or credit.

In *Gainer v. Commissioner of Internal Revenue*, 893 F.2d 225 (9th Cir. 1990), the Ninth Circuit Court of Appeals adopted this same reasoning. The Court held that because the underpayment was not "attributable to" any overstatement of value the Section 6659 penalty could not be imposed.

The Second and Eighth Circuit Courts of Appeals have chosen a different path to affirm imposition of the Section 6659 penalty. In *Gilman v. Commissioner of Internal Revenue*, 933 F2d 143 (2nd Cir. 1991) and *Massengill v. Commissioner of Internal Revenue*, 876 F.2d 616 (8th Cir. 1989), those Courts of Appeals took the approach of following congressional intent. The courts found that

where the lack of economic substance was due in part to the overvaluation, the underpayment was attributable to the valuation overstatement.

In this case the Tax Court followed the reasoning of the Second Circuit in *Gilman*. The Tax Court held that where there is a lack of economic substance, Section 6659 will apply because the correct basis is zero and any basis claimed in excess of that is a valuation overstatement.

On appeal the Sixth Circuit Court of Appeals followed both the decisions in *Gilman*, as well as *Massengill*. The court found that the tax benefit generated by the Cassette transaction was directly dependent upon the valuation overstatement, and the amount of the tax benefit was actually determined by the amount of the overvaluation. The Sixth Circuit Court of Appeals found that the decisions in *Todd* and *Gainer* were inapposite to Illes.

The Sixth Circuit Court of Appeals has misinterpreted the decisions of *Heasley, Gainer* and *Todd*. The court found that had it not been for the valuation overstatement, Illes would not have underpaid his taxes. Nothing could be further from the truth. Kerry W. Illes' tax liability would be the same regardless of what value he placed on the Cassette assets because there were no assets to place in service. Therefore, any discussion of value would be irrelevant to the determination as to the reason for the underpayment of tax.

In summary, the test for determining whether an underpayment resulted from a valuation overstatement should be a comparison of the taxpayer's actual tax liability (without the improperly claimed deductions) with their claimed liability. That test exists in the Fifth and Ninth Circuit Courts of Appeals. It is also an accurate barometer for determining whether an underpayment of taxes is attributable to a valuation overstatement. Accordingly, this Court should exercise its discretion to resolve this conflict

between the Circuits and reverse the Circuit Court of Appeals decision in this case.

IV.

THE DECISION OF THE SIXTH CIRCUIT COURT OF APPEALS IN THIS CASE CONFLICTS WITH THE DECISIONS OF THE FIFTH AND NINTH CIRCUIT COURTS OF APPEALS WHICH REFUSE TO IMPOSE PENALTIES FOR SUBSTANTIAL UNDERSTATEMENT OF INCOME TAXES WHERE THE TAXPAYER RELIES IN GOOD FAITH UPON THE INVESTMENT ADVICE OF HIS OR HER ACCOUNTANT.

Internal Revenue Code Section 6661 imposes an addition to tax on that portion of an underpayment that is a substantial understatement. The penalty may be waived on a showing by the taxpayer that there was reasonable cause for the understatement and the taxpayer acted in good faith.

The Fifth Circuit Court of Appeals in *Heasley v. Commissioner of Internal Revenue*, 902 F.2d 380 (5th Cir. 1990) and the Ninth Circuit Court of Appeals in *Vorsheck v. Commissioner of Internal Revenue*, 933 F.2d 757 (9th Cir. 1991), have examined this addition to tax and have held that if it was reasonable for the taxpayer to rely upon the advice of an accountant under the circumstances, and the taxpayer did so in good faith, then the Commissioner may waive the penalty.

In this case the Tax Court found that Kerry Illes was negligent in claiming the deductions and credits and failed to make a good faith effort to determine the proper tax treatment of the tax items involved. The court stated that there was no showing of reasonable cause for the understatement.

On appeal the Sixth Circuit Court of Appeals affirmed the reasoning of the Tax Court. It held that Illes' reliance on Thomas A. Graham as his accountant was unreasonable because Graham was not a disinterested source.

The *Heasley* and *Vorsheck* decisions demonstrate the reasonableness standard as it is applied to Section 6661. The decision of the Sixth Circuit Court of Appeals herein ignores those findings. Kerry W. Illes acted reasonably and in good faith under the circumstances. He invested with a firm (Graham & Associates) and later relied on Thomas A. Graham to prepare his tax returns. Kerry Illes had no knowledge that Graham was an interested party. Accordingly, the Sixth Circuit has erred in its analysis of the facts and circumstances in this case. The taxpayer relied in good faith upon the investment advice of his accountant.

As such, this Court should exercise its discretion to resolve this conflict between the Fifth, Ninth and Sixth Circuits and reverse the Sixth Circuit Court of Appeals decision in this case.

V.

THE DECISION OF THE SIXTH CIRCUIT COURT OF APPEALS IN THIS CASE CONFLICTS WITH THE DECISION OF THE FIFTH CIRCUIT COURT OF APPEALS IN *HEASLEY v. COMMISSIONER*, 902 F.2d 380 (5TH CIR. 1990), REGARDING THE IMPOSITION OF THE TAX MOTIVATED INTEREST PENALTY AND ITS APPLICATION TO TRANSACTIONS ENTERED INTO FOR PROFIT.

Internal Revenue Code Section 6621(c) imposes an addition to tax for any substantial understatement of tax liability attributable to a tax motivated transaction. A tax motivated transaction includes a valuation overstatement as that term is defined in Section 6659.

The Fifth Circuit Court of Appeals in *Heasley v. Commissioner of Internal Revenue*, 902 F.2d 380 (5th Cir. 1990) addressed the addition to tax under Section 6621(c) and its correlation with Section 6659. The court held that the Heasleys established a reasonable basis for their valuation overstatement and that they acted in good faith. The court found that the Internal Revenue Service had abused its discretion by failing to waive the penalty and the Tax Court erred in upholding the Service's decision.

In this case the Tax Court methodically asserted the addition to tax under Section 6621(c). The court found that because there was a valuation overstatement and the transaction lacked economic substance, the addition to tax for tax motivated interest was properly asserted.

On appeal the Sixth Circuit Court of Appeals affirmed the decision of the Tax Court utilizing the same reasoning.

Instead of applying the *Heasley* analysis prescribed by the Fifth Circuit Court of Appeals, the Circuit Court in this case focused on the hindsight analysis which found that Kerry Illes' actions were unreasonable under the circumstances. If the court had applied the *Heasley* analysis (*i.e.*, focus on the taxpayer's intent at time of entering transaction) the court would have found the requisite good faith and reasonableness exercised by Mr. Illes herein. Accordingly, this Court should exercise its discretion to resolve this conflict and reverse the decision of the Sixth Circuit Court of Appeals in this case.

The petitioner would submit that the Sixth Circuit decision seriously misreads the intent of Congress and may well serve to inhibit moderate income investor such as Kerry W. Illes from participating in legitimate investment transactions. This decision by the Sixth Circuit Court of Appeals represents such a departure

from past court practice that this Court should exercise its power of supervision as called for by Rule 10.1(a) and 10.1(c) of the Rules of the Supreme Court.

CONCLUSION

For the reasons hereinabove discussed, the petitioner urges this Court to grant the writ of certiorari.

Respectfully submitted,

MARK E. GAMMONS
Attorney for Petitioner

APPENDIX A – DECISION OF THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT FILED SEPTEMBER 21, 1992

NOT FOR PUBLICATION

No. 91-2412

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

KERRY W. ILLES,

Petitioner-Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

ON APPEAL FROM THE DECISION OF THE UNITED STATES TAX COURT

BEFORE: NELSON, NORRIS, and SUHRHEINRICH, Circuit Judges.

PER CURIAM. Taxpayer Kerry W. Illes appeals from the Tax Court's determination that he is liable for deficiencies and penalties as a result of his investment in a tax shelter that lacked economic substance. We AFFIRM.

I.

During 1984 and 1985, Structured Shelters, Inc. ("SSI")

through its agent Thomas A. Graham, marketed a product called Children's Classics Audio Cassettes ("CCAC"). The CCAC promotion had two phases, a production phase and a lease phase. The 1985 production phase involved the purchase of the right to reproduce artwork and to use titles for the products of new master cassette recordings from Sonya, Inc. Sonya had in turn purchased these rights from the investors in SSI's 1981 promotion of master recordings of children's stories. Thomas Graham and his wife were the majority shareholders of Sonya.

As part of the 1985 production phase, investors purchased four titles from Sonya for $115,000; each payment consisting of $25,000 cash and the remainder in a nonrecourse note. The 1985 production phase investors also entered into agreements with Marketing Complex, Inc. ("MCI") to develop an advertisement program. Payment of that agreement included $2,000 in cash and a note for $6,000.

In the 1985 lease phase of the CCAC promotion, investors leased for a term of five years the right to produce cassette tapes from the master recordings that were to be developed by the CCAC production phase investors. The 1985 lease phase investors agreed to pay $16,700; which was comprised of $4,175 in cash and $12,525 in nonrecourse notes. These investors also contracted with MCI for marketing services, paying $2,000 in cash and $6,000 in notes.

In 1984, Graham hired taxpayer Kerry Illes, an architect, to perform some work for him. Graham in turn persuaded taxpayer to invest in the CCAC program. Illes then hired Graham to be his accountant. Illes purchased one title as a 1985 production phase investor and leased the right to reproduce another as a 1985 lease phase investor. On his 1985 federal income tax return, taxpayer

claimed deductions totaling $61,775 and an investment tax credit of $5,473. The Commission of the Internal Revenue ("the Commissioner") disallowed the claimed deductions and credit and also assessed various additions to tax and an increased interest rate for Illes's underpayment based on its conclusion that the enterprise lacked economic substance. The Tax Court upheld the Commissioner's decision in all respects.

Taxpayer stipulated in the Tax Court that both the 1985 CCAC production phase and the 1985 CCAC lease phase investments had no economic substance. He therefore does not contest the disallowance of deductions and credits based on these investments. However, taxpayer contends that he should be allowed to deduct his out-of-pocket expenditures made for these investments on the grounds that the losses were incurred in a transaction entered into for profit. Illes also challenges each of the additions to tax and the use of the increased interest rate.

II

A.

To be valid, an asserted deduction must satisfy both components of a two-part test. The threshold question is whether the transaction has economic substance. If the answer is yes, the question becomes whether the taxpayer was motivated by profit to participate in the transaction. *Rose v. Commissioner,* 868 F.2d 851, 853 (6th Cir. 1989); *Mahoney v. Commissioner,* 808 F.2d 1219, 1220 (6th Cir. 1987). If, however, the court determines that the transaction is a sham, the entire transaction is disallowed for federal tax purposes, and the second inquiry is never made. *Id.* Illes has stipulated that the CCAC transaction lacked economic substance. Therefore, the Commissioner properly disallowed the

claimed section 165(c)(2) deduction, regardless of whether Illes was actually, honestly, and exclusively motivated by profit.

Illes argues that, because he reasonably believed the CCAC transaction had economic substance, the first part of the *Mahoney* test is satisfied. In support of this argument, Illes advances a contorted reading of our decisions in *Rose* and *Bryant v. Commissioner*, 928 F.2d 745 (6th Cir. 1991). In these cases, we ruled that the proper test for whether "a transaction is a sham is whether the transaction has any practicable economic effects other than the creation of income tax losses. A taxpayer's subjective business purpose . . . may be relevant to this inquiry." *Bryant*, 928 F.2d at 748 (quoting *Rose*, 868 F.2d at 853 (citations omitted)). Illes reads this passage to mean that because he reasonably and actually believed the CCAC transaction was not a sham, it must be regarded as not a sham for section 165(c)(2) purposes.

Illes's interpretation conflates the two quite distinct parts of the *Mahoney* test. The first part consists of an examination of the transaction, not the taxpayer. If the transaction lacks economic substance, then the deduction must be disallowed without regard to the "niceties" of the taxpayer's intent. *Mahoney*, 808 F.2d at 1220. Moreover, Illes's interpretation would undermine the purpose of the *Mahoney* test by requiring us to first make the more difficult determination of the taxpayer's intent. *Cf. Bryant*, 928 F.2d at 749.

B.

The Commissioner found that Illes had underpaid his 1985 income tax due to negligence and therefore was subject to an addition to tax under I.R.C. § 6653(a)(1) & (2). The Tax Court upheld the Commissioner's determination. Illes argues that he reasonably relied on the professional advice of his accountant, Thomas Graham.

Appendix A

The Commissioner's finding that an underpayment was caused by a taxpayer's negligence is presumptively correct, and the taxpayer who would have it overruled bears the burden of proving that he was not negligent. Moreover, we review the Tax Court's findings of fact regarding negligence for clear error. *Leuhsler v. Commissioner,* 963 F.2d 907, 910 (6th Cir. 1992); *Skeen v. Commissioner,* 864 F.2d 93, 96 (9th Cir. 1989). "Negligence" as found in section 6653, is given its general definition, that is, "a lack of due care or a failure to do what a reasonable person would do under the circumstances." *Leuhsler,* 963 F.2d at 910.

Other than offering the vague assertion that Graham "suggested that this was a good investment to make for a retirement type situation"; Illes has presented no evidence regarding any advice Graham offered in connection with the CCAC transaction. This is not sufficient to meet Illes's burden of proving that a reasonable person would have relied upon the Graham's advice. *See Howard v. Commissioner,* 931 F.2d 578, 582 (9th Cir. 1991); *Skeen,* 864 F.2d at 96, *adopted in Gomberg v. Commissioner,* 868 F.2d 865, 866-67 (6th Cir. 1989).

Illes responds by arguing that rather than specific advice, he relied on Graham's reputation. Illes introduced no evidence whatsoever of Graham's reputation, however. In fact, the only basis for reliance offered by Illes was the fact that, while a client of Illes, Graham paid his bills as submitted. The Tax Court found that a reasonable person who knew Graham had a personal stake in the CCAC venture would not commit nearly $150,000 before investigating the transaction independently and seeking independent advice. We cannot say this conclusion is clearly erroneous. *See Leuhsler,* 963 F.2d at 910-11.

Illes's attempt to equate himself with the taxpayers in *Heasley v. Commissioner,* 902 F.2d 380 (5th Cir. 1990) is utterly misguided.

Appendix A

Unlike the taxpayers in *Heasley,* Illes is a college graduate, who, for a number of years, has run his own architecture firm. More importantly, in direct contrast with the Heasleys, Illes offered no proof that he ever investigated the investment or sought independent professional advice on the validity and viability of the investments. Nor can Illes's asserted reliance on his accountant be viewed as reasonable, since Graham was not a disinterested source. Taxpayer has therefore failed to meet his burden of proof.

C.

The Commissioner also assessed an addition to tax against Illes because his tax underpayment resulted from a valuation overstatement. I.R.C. § 6659. Illes admits that the value he ascribed to his interest in CCAC assets exceeded their correct value by more than 250% but claims that his underpayment is not attributable to the valuation overstatement. Since his underpayment is the result of the CCAC being an economic sham, Illes argues that the underpayment is attributable to his claiming an improper deduction rather than to a valuation overstatement.

This is a false distinction. The tax benefit generated by the CCAC shelter was directly dependent upon the valuation overstatement, and the amount of the tax benefit was actually determined by the amount of the overvaluation. The entire artifice of the CCAC shelter was constructed on the foundation of the overvaluation of its assets. Plainly, then, Illes's underpayment was attributable to his valuation overstatement. As the Eighth Circuit has ruled, "When an underpayment stems from disallowed depreciation deductions or investment credit due to lack of economic substance, the deficiency is attributable to overstatement of value, and subject to the penalty under section 6659." *Massengill v. Commissioner,* 876 F.2d 616, 619-20 (8th

Cir. 1989); *accord Donahue v. Commissioner,* No. 91-1849, 1992 U.S. App. LEXIS 7139, *13-*16 (6th Cir. Apr. 7, 1992) (unpublished per curiam); *Gilman v. Commissioner,* 933 F.2d 143, 151 (2d Cir. 1991), *cert. denied,* 116 L. Ed. 2d 776 (1992).

Contrary to Illes's assertion, *Todd v. Commissioner,* 862 F.2d 540 (5th Cir. 1988), and *Gainer v. Commissioner,* 893 F.2d 225 (9th Cir. 1990), are inapposite. In both of those cases, the claimed deductions were disallowed because the property at issue was not put into service in the tax year for which the deduction and credit were claimed. Thus, the claimed deduction was improper without regard to whether the investors overvalued their interests in the property. As such, the underpayment was held not attributable to the overvaluation for the purposes of section 6659. *Todd,* 862 F.2d at 542-43; *Gainer,* 893 F.2d at 227-28.[1]

This is not the case with the CCAC shelter. Had it not been for the valuation overstatement, Illes would not have underpaid his taxes. Thus, *Todd* and *Gainer* are inapposite to Illes's claim. We adopted this distinction in *Donahue,* 1992 U.S. App. LEXIS 3719, at *12-*13.

D.

The Commissioner also assessed an addition to Illes's tax under I.R.C. § 6661, which provides for an addition where "there is a substantial understatement of income tax." Under subsection (c), the Commissioner has discretion to waive this addition if there was

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1. Illes does not cite *Heasley* in support of this argument even though the tax shelter involved there is more closely analogous to the CCAC scheme than is the FoodSource shelter. Nevertheless, *Donahue* also distinguished *Heasley* in a manner that renders it inapposite to this case. *Donahue,* 1992 U.S. App. LEXIS 7139, at *12.

reasonable cause for the understatement and the taxpayer acted in good faith. I.R.C. § 6661(c). Illes resurrects his argument that he reasonably and in good faith relied on the advice of his accountant. For the reasons set forth in Part B, this argument is unavailing.

E.

For substantial underpayments, those exceeding one thousand dollars, that are attributable to tax motivated transactions, the rate of interest is 120% of the standard underpayment rate. I.R.C. § 6621(c). Illes admits that if we affirm either the addition assessed under section 6659 or the finding that he did not act reasonably, then the interest was properly computed under section 6621(c). *See Gomberg,* 868 F.2d at 866-67; *Gilman,* 933 F.2d at 152. We have affirmed both and therefore affirm the Commissioner's interest computation.

F.

For the foregoing reasons, we AFFIRM the Tax Court in all respects.

APPENDIX B – ORDER AND DECISION OF THE UNITED STATES TAX COURT ENTERED OCTOBER 1, 1991

UNITED STATES TAX COURT
WASHINGTON, D.C. 20217

Docket No. 9616-90

KERRY W. ILLES,

Petitioner(s)

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

ORDER AND DECISION

For cause, it is

ORDERED that the Court's Decision entered September 19, 1991, is hereby vacated and set aside.

Pursuant to the determination of the Court, as set forth in T.C. Memo. 1991-449, filed September 16, 1991, it is

ORDERED AND DECIDED that there is a deficiency in petitioner's income tax and additions to tax as follows:

Appendix B

Year	Deficiency	Additions to Tax	
1985	$34,908.00	Sec.6653(a)(1)	$1,745
		Sec. 6653(a)(2)	*
		Sec. 6659(a)	5,698
		Sec. 6661(a)	3,979

* 50 percent of the statutory interest on $34,908

The total deficiency in income tax due from petitioner for the calendar year 1985 is a substantial underpayment attributable to tax motivated transactions, and interest payable with respect to the deficiency is subject to the provisions of section 6621(d), Internal Revenue Code, redesignated as section 6621(c).

(Signed) Wm. M. Fay
William M. Fay
Judge

Entered: Oct 1 1991

APPENDIX C – ORDER AND DECISION OF THE UNITED STATES TAX COURT ENTERED SEPTEMBER 19, 1991

UNITED STATES TAX COURT
WASHINGTON, D.C. 20217

Docket No. 9616-90

KERRY W. ILLES,

Petitioner(s)

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

DECISION

Pursuant to the determination of the Court, as set forth in T.C. Memo. 1991-449, filed September 16, 1991, it is

ORDERED AND DECIDED that there is a deficiency in petitioner's income tax and additions to tax as follows:

Year	Deficiency	Additions to Tax	
1985	$34,908.00	Sec.6653(a)(1)	$1,745
		Sec. 6653(a)(2)	*
		Sec. 6659(a)	5,698
		Sec. 6661(a)	3,979

* 50 percent of the statutory interest on $34,908

Appendix C

Wm. M. Fay
William M. Fay
Judge

Entered: Sep 19 1991

APPENDIX D — MEMORANDUM FINDINGS OF FACT AND OPINION OF THE UNITED STATES TAX COURT FILED SEPTEMBER 16, 1991

T.C. Memo. 1991-449

UNITED STATES TAX COURT

KERRY W. ILLES, Petitioner *v.* COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 9616-90. Filed September 16, 1991.

Mark E. Gammons, for the petitioner.

Dawn M. Krause, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

FAY, *Judge:* This case has been assigned to Chief Special Trial Judge Marvin F. Peterson pursuant to the provisions of section 7443A(b) and Rules 180, 181, and 183. All section references are to the Internal Revenue Code as amended and in effect for the year in issue. All Rule references are to the Tax Court Rules of Practice and Procedure. The Court agrees with and adopts the Chief Special Trial Judge's opinion, which is set forth below.

OPINION OF THE SPECIAL TRIAL JUDGE

PETERSON, *Chief Special Trial Judge:* Respondent determined a deficiency in petitioner's income tax and additions to tax as follows:

Appendix D

Year	Deficiency	Additions to Tax	
1985	$34,908.00	Sec.6653(a)(1)	$1,745
		Sec. 6653(a)(2)	*
		Sec. 6659(a)	5,698
		Sec. 6661(a)	3,979

* 50 percent of the statutory interest on $34,908

After concessions by petitioner, the issues remaining for decision are (1) whether petitioner is entitled to a deduction under section 165(c)(2) for cash expenditures made for an investment which was an economic sham; and (2) whether petitioner is liable for additions to tax pursuant to sections 6653, 6659, and 6661, and for increased interest pursuant to section 6621(c). In his Answer, respondent has affirmatively raised the issue of whether petitioner is liable for increased interest pursuant to section 6621(c).

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts and accompanying exhibits are incorporated herein by this reference. Petitioner resided in Medina, Ohio, when the petition in this case was filed.

During 1981, Structured Shelters, Inc. (SSI), marketed an investment entitled Children's Classic Series (1981 Record Promotion). This promotion involved the leasing of master recordings of children's stories for the purpose of producing record albums, described in detail in *Rybak v. Commissioner,* 91 T.C. 524 (1988). SSI used sales agents, called chartered representatives, to market various tax motivated investments, including the 1981 Record Promotion. Thomas A. Graham (Mr. Graham) was a

chartered representative of SSI.

The master recordings used in the Children's Classic Series were purchased by Oxford Productions (Oxford) for $454,120. The purchase agreement required a cash payment in the amount of $7,000 and the execution of a nonrecourse note in the amount of $447,120. The cost to produce each master recording was $1,635.50. Oxford leased the master recordings to investors of the 1981 Record Promotion for an 8-year term. The lease required an advance rental payment of $10,000 in cash plus 25 percent of all gross revenues during the lease period.

A part of the 1981 Record Promotion included a distribution agreement between the investors and Aim Record Distribution (Aim) which provided that Aim would produce and market the records. The investors agreed to pay Aim $2,500 cash plus 10 percent of the gross receipts from record sales. Of the $2,500 payment, 15 percent was allocated to the cost of producing the record album jacket. Aim developed artwork for the album jackets for the 1981 Record Promotion investors.

During 1984, SSI, on behalf of the 1981 Record Promotion investors, sold the rights to reproduce the artwork and to use the titles of the record albums to Sonya, Inc. (Sonya), for $100,000 for each title. The purchase price consisted of a cash payment of $10,000, the assumption of a $6,000 note, and the payment of the $84,000 balance from future sales of children's cassette tapes. The $100,000 sales price was an arbitrary figure which had no relationship to the value of the right to use the titles sold to Sonya. Neither SSI nor the 1981 Record Promotion investors had the exclusive rights to the record titles or to the artwork sold to Sonya. Graham and his spouse owned 65 percent of the stock in Sonya.

During 1984, SSI and Graham began to market an investment

called Children's Classics Audio Cassettes (CCAC). There were two phases to this program. The first phase involved the production of master recordings (CCAC Production Phase) using the titles and artwork purchased by Sonya from the 1981 Record Promotion investors. The second phase involved leasing the master recordings (CCAC Lease Phase) from the CCAC Production Phase investors to produce cassette tapes.

An integral part of the scheme was Sonya's sale in December 1984 to the CCAC Production Phase investors (1984 CCAC Production Phase) of the right to reproduce the artwork and to use the record titles which it had purchased from the 1981 Record Promotion investors. The sales price was $103,000 for each title. The sales agreement required a cash payment of $13,000 with the balance due of $90,000 to be paid within 5 years from future sales of cassette tapes.

Each CCAC Production Phase investor entered into an agreement with Skeets Music (Skeets) under which Skeets agreed to produce the master recordings and artwork for $20,000, of which $5,000 was paid in cash and the balance was to be paid from future sales of cassette tapes. Also, a marketing agreement was entered into with Marketing Complex, Inc. (MCI) to develop an advertising plan for the cassette tapes. The investors agreed to pay MCI $7,500, of which $1,500 was paid in cash, and a $6,000 promissory note due in 5 years was executed for the balance due.

During 1984, the CCAC Production Phase investors leased to the CCAC Lease Phase investors (1984 Lease Phase) the right to produce cassette tapes from the master recordings developed for the 1984 CCAC Production Phase investors. The lease was for a term of 5 years and required the lessee to pay $1 each for a minimum of 10,000 tapes. A cash payment of $2,500 was made and the balance of $7,500 was due in 5 years. The 1984 CCAC Lease

Appendix D

Phase investors entered into an agreement with MCI to develop an advertising plan. The investors agreed to pay MCI $7,500, of which $1,500 was paid in cash and a $6,000 promissory note due in 5 years was executed for the balance due.

During 1985, Sonya sold additional record titles and artwork to CCAC Production Phase investors (CCAC 1985 Production Phase) for $115,000 per title. The agreement provided for a cash payment of $25,000 with the remaining balance due of $90,000 to be paid within 5 years from the future sales of cassette tapes. Included in the sale price was the production cost of $5,000 which Sonya paid directly to Skeets. None of the investors entered into production agreements to produce master recordings. The 1985 CCAC Production Phase investors entered into an advertising agreement with MCI to develop an advertising plan. The investors agreed to pay MCI $8,000, of which $2,000 was paid in cash and a $6,000 promissory note due in 5 years was executed for the balance due.

During 1985, the CCAC 1984 and 1985 Production Phase investors leased to the CCAC Lease Phase investors (1985 CCAC Lease Phase investors) the right to produce cassette tapes from the master recordings purportedly developed for the 1984 and 1985 CCAC Production Phase investors. The lease was for a period of 5 years and required the lessee to pay $1.67 each for a minimum of 10,000 tapes. A cash payment of $4,175 was paid and the balance of $12,525 was to be paid from future sales of cassette tapes during the term of the lease. The 1985 Lease Phase investors entered into an agreement with MCI to develop an advertising plan. The investors agreed to pay MCI $8,000, of which $2,000 was paid in cash and a $6,000 promissory note due in 5 years was executed for the balance due.

The cassette tapes and artwork were primitive, of very poor

quality, and clearly substandard to cassette tapes sold in the customary retail market. As of the date of trial, there had been no sales of such cassette tapes. Because of their poor quality, it was highly unlikely that there would ever be a market for cassettes tapes produced from the master recordings leased by the investors. Under these circumstances the master recordings, leases, and artwork had no commercial value.

The total amount of cash invested by the 1984 CCAC Production Phase investors was $19,500 for each master recording. The total amount of projected tax benefits for each investor was between $115,000 and $119,000.

The total amount of cash invested by the 1985 CCAC Production Phase investors was $27,000 for each master recording. The total amount of projected tax benefits for each investor was $126,300.

The total amount of cash invested by the 1984 CCAC Lease Phase investors was $4,000 for each lease. The total amount of projected tax benefits for each investor was $17,500.

The total amount of cash invested by the 1985 CCAC Lease Phase investors was $6,175 for each lease. The total amount of projected tax benefits for each investor was $24,700.

During 1985, petitioner entered into an agreement with Sonya, Inc., to purchase for $115,000 the rights for the limited use of the artwork and the title for the story of "Renowned Bedtime Stories" for the production of a master recording. Petitioner made a downpayment of $25,000, with the balance of $90,000 due in 5 years. Petitioner also entered into an advertising agreement with MCI for $8,000, of which $2,000 was paid in cash. Petitioner

executed a $6,000 promissory note payable from future sales of cassette tapes and any balance was due in 5 years. Petitioner expected to receive tax deductions in the amount of $119,700 and an investment tax credit of $6,000 from his cash investment of $27,000.

During 1985, petitioner entered into an agreement with Sonya, Inc., to lease a master recording entitled "Jokes and Riddles" to produce cassette tapes. Petitioner agreed to an advance rental payment of $16,700, of which $4,175 was paid in cash and the balance was due in 5 years. Petitioner entered into an advertising agreement with MCI for $8,000, of which $2,000 was payable in cash, and petitioner executed a $6,000 promissory note payable from future sales of cassette tapes and any balance was due in 5 years. Petitioner expected to receive tax deductions for advertising and lease expense in the amount of $24,700 from his cash investment of $6,175.

At the time of the investments in the master recording and the lease, petitioner had no background in or knowledge of the record or tape cassette business. Petitioner did not make any investigation concerning the nature or the profitability of the CCAC investments and accepted at face value Mr. Graham's statement that the CCAC investments were suitable for his retirement program. He failed to review the various documents he signed and did not negotiate any of the contract terms. Petitioner did not investigate the experience or the financial background of any of the entities involved in the CCAC transactions to determine whether such entities had the capability to produce and distribute cassette tapes in the retail market. Petitioner made no attempt to obtain an appraisal of the master recording or the lease, or make any other investigation to determine their values. Petitioner made no attempt to either verify Mr. Graham's tax advice with an independent tax authority, or verify whether Mr. Graham had any experience in the recording

business or was knowledgeable in investment or tax matters. Petitioner has been a self-employed architect for many years and had little or no experience in tax matters.

Petitioner's decision to invest in the 1985 CCAC Production Phase and 1985 CCAC Lease Phase was based on the promised tax benefits and not on an actual and honest profit motive.

OPINION

Petitioner admits that the investments made in the 1985 CCAC Production Phase and the 1985 CCAC Lease Phase had no economic substance and agrees that he is not entitled to any tax credits or deductions based on these investments. However, petitioner contends that he is entitled to deduct the cash payments made for these investments under section 165(c)(2) on the ground that the losses were incurred in a transaction entered into for profit. Although admitting that the transactions were economic shams, he contends that he had no knowledge at the time he entered into the transactions that the investments lacked economic substance. Petitioner contends that he felt that he needed additional money to fund his retirement, and on the advice of Mr. Graham, used some of his retirement savings for the CCAC investments with the hope of receiving a substantial monetary return. Therefore, petitioner argues that tax motivation was incidental to the CCAC investments because he felt that the investment would have a 20-to-1 return from the sale of cassette tapes which would be sufficient to meet his investment needs without regard to any tax benefits. Further, petitioner argues that because of his lack of knowledge in investments and tax planning, it is clear that he relied on the reputation of Mr. Graham, as an expert in investment matters, that there would be substantial earnings and profits from the sale of cassette tapes.

Appendix D

Respondent argues that petitioner has failed to show that a loss was sustained, or the amount of any loss as required under section 165(c)(2). In addition, respondent contends that petitioner has failed to show that he had a profit motive when he entered into the CCAC transactions.

The transactions involved in the instant case are a continuation of the tax shelter promotion scheme by SSI concerning master recordings of children's records described in detail in *Rybak v. Commissioner,* 91 T.C. 524 (1988).

In the original 1981 promotion the investors produced master recordings for the alleged purpose of producing and distributing records in the children's retail market which the Court found was an economic sham. In the instant case petitioner indirectly acquired the right to use song titles and artwork from investors in the 1981 Record Promotion to produce a master recording and leased a master recording to produce cassette tapes from an investor who also acquired the song title and artwork indirectly from an investor in the 1981 Record Promotion.

To resolve the question of whether petitioner had a profit motive, we must look to all of the facts and circumstances. *Fox v. Commissioner,* 82 T.C. 1001, 1022 (1984). Petitioner has the burden of proof to show such profit motive. Rule 142(a).

The facts in this case are essentially the same as set forth in *Rybak v. Commissioner, supra.* The only material difference is that in the instant case petitioner purchased a master recording through SSI to produce children's cassette tapes rather than records. Petitioner also leased a master recording to produce children's cassette tapes. Petitioner admits that these transactions were without economic substance the same as in the *Rybak* case.

Appendix D

As to petitioner's profit motive we come to the same conclusion as we did in *Rybak,* that the investments were made solely for the tax benefits. Petitioner admitted as much when he testified that the tax savings from the CCAC transactions would allow him to make the initlal investments. When petitioner entered into the transactions he expected to receive at least a 2-to-1 payback based on the investment credit and tax deductions no matter what happened to the sale of cassette tapes. Petitioner executed contracts without negotiation. The value of the master recordings was only a fraction of the purchase price, and most of the purchase and lease payments were deferred and would only be paid from sales revenues. At the time of the investments petitioner had no background or knowledge of the record or cassette tape business. In spite of this lack of background or experience, he made no effort to consult with anyone with experience in the record and cassette tape industry, or to obtain appraisals to determine whether the investments had substance and commercial viability. Petitioner may have relied on Mr. Graham, but the information received focused on the substantial tax benefits involved and not on the advisability of investing in the recording business to produce children's cassette tapes. These facts lead us to the conclusion that petitioner had no profit motive other than for the tax benefits. See *Rybak v. Commissioner, supra* at 536.

There is no doubt that the various master recording programs set forth above were nothing more than economic shams without a business or profit motive. The facts involved in this case show that petitioner did not have an actual and honest objective of making a profit, but entered into the transactions for the sole purpose of obtaining income tax benefits.

Even if we were to assume that petitioner had a profit motive, petitioner could not prevail in this case because the transactions lacked economic substance. See *Cherin v. Commissioner,* 89 T.C.

986, 993-994, (1987), where we held that the presence of an individual's profit motive does not require the recognition for tax purposes of a transaction which lacks economic substance.

In *Jackson v. Commissioner,* T.C. Memo. 1991-250, we denied a deduction for "out of pocket cash losses" on the ground that the transaction lacked economic substance even though the taxpayers may have entered into the transaction for profit.

Also, in *Shriver v. Commissioner,* 899 F.2d 724 (8th Cir. 1990), affg. a Memorandum Opinion of this Court, the court concluded, as an alternative basis for its holding that the deductions claimed were not deductible, that where there is a clear finding of a lack of economic substance it is enough, standing alone, to support a decision that a deduction is not allowable. In *Mahoney v. Commissioner,* 808 F.2d 1219 (6th Cir. 1987), affg. *Forseth v. Commissioner,* 85 T.C. 127 (1985), the Court of Appeals held that if a transaction is a complete sham, then such niceties as whether the test (for whether a transaction is "entered into for profit") is an objective or subjective one are simply not involved. Regardless of the definition, the transaction must be bona fide before losses are deductible.

For the above reasons, we sustain respondent's determination that petitioner is not entitled to a loss deduction under section 165(c)(2) for the cash payments invested in the CCAC transactions because the transactions involved lacked economic substance and were not entered into for profit.

Additions to Tax

Section 6653(a)

Respondent determined that petitioner is liable for additions

to tax under section 6653(a)(1) and (2). Section 6653(a)(1) imposes an addition to tax if any part of an underpayment of tax is due to negligence or intentional disregard of rules and regulations. Section 6653(a)(2) imposes an additional amount, but only with respect to the portion of the underpayment attributable to the negligence. Negligence is the lack of due care or failure to do what a reasonable and ordinarily prudent person would do under the circumstances. *Neely v. Commissioner,* 85 T.C. 934, 947 (1985).

Petitioner contends that he was not negligent because he placed his reliance completely on Mr. Graham, the sales representative of SSI, who petitioner felt had a good reputation in tax and investment matters. We agree that reliance on the advice of professionals may defeat a finding of negligence under certain circumstances. *Industrial Valley Bank & Trust Co. v. Commissioner,* 66 T.C. 272, 283 (1976). See *Coleman v. Commissioner,* T.C. Memo. 1990-511. Petitioner has the burden of proof to show that he was not negligent. *Luman v. Commissioner,* 79 T.C. 846, 860-861 (1982).

There is no evidence in this record that Mr. Graham had any experience in the record or cassette tape recording business. Petitioner made no attempt to personally verify whether Mr. Graham had any such experience, or whether he was knowledgeable in investment and tax matters. Petitioner testified that he relied on Mr. Graham's reputation when he entered into the transactions. However, petitioner failed to explain the basis for his complete faith in Mr. Graham's reputation. Apparently, petitioner did not see any conflict in the fact that Mr. Graham had a financial interest in the transactions. Under these circumstances, reasonable caution dictates that further inquiry be made to verify the accuracy of the tax and investment information received. We do not believe that petitioner would have committed nearly $150,000 to these

transactions without seeking independent advice if he were truly concerned about his investments, other than for the tax benefits involved. We find no evidence that petitioner's actions were prudent or reasonable under the circumstances of this case. Accordingly, petitioner is liable for the additions to tax for negligence as determined by respondent.

Section 6659

Section 6659 imposes a graduated addition to tax whenever an individual has an underpayment of tax which equals or exceeds $1,000 and which is attributable to a valuation overstatement. A valuation overstatement occurs when "the value of any property, or the adjusted basis of any property, claimed on any return is 150 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be)." Sec. 6659(c).

Petitioner argues that the addition under section 6659 does not apply to this case because the underpayment is attributable to claiming an improper deduction rather that to a valuation overstatement.

In the instant case, the deductions and investment tax credits were disallowed because the transactions lacked economic substance which included a finding that the property was overvalued. Where there is a lack of economic substance, section 6659 will apply because the correct basis is zero and any basis claimed in excess of that is a valuation overstatement. *Rybak v. Commissioner,* 91 T.C. 524, 566-567 (1988); *Gilman v. Commissioner,* 933 F.2d 143 (2d Cir. 1991), affg. T.C. Memo. 1989-684. In affirming *Gilman v. Commissioner, supra,* the Court of Appeals agreed with the proposition that where a deduction is

disallowed due to the lack of economic substance and the lack of economic substance is due in part to an overvaluation, the deficiency is attributable to a valuation overstatement under section 6659. *Gilman v. Commissioner,* 933 F.2d at 151. See also *Harness v. Commissioner,* T.C. Memo. 1991-321.

Section 6661

Respondent has also determined that the addition to tax under section 6661 applies in this case. Petitioner does not dispute that there was an understatement of tax as defined in section 6661, but argues that the addition to tax should be waived on the ground that petitioner made the investment in good faith. Respondent contends that the deductions and credit claimed on petitioner's return are attributable to a tax shelter and that petitioner is liable for the addition to tax since he has failed to show that there was substantial authority for his position and that he reasonably believed his tax treatment of the items were more likely than not the proper treatment. We agree with respondent. Sec. 6661(b)(2)(C)(i). We also agree with respondent that petitioner has failed to show that respondent abused his authority in not waiving the addition to tax. *Mailman v. Commissioner,* 91 T.C. 1079, 1084 (1988). There is no showing by petitioner of reasonable cause for the understatement and that he acted in good faith. To the contrary, we have found that petitioner was negligent in claiming the deductions and credit and failed to make a good faith effort to determine the proper tax treatment of the tax items involved. See *Mailman v. Commissioner,* 91 T.C. 1079 (1988).

Increased Interest

In his Answer, respondent raised the issue of whether petitioner is liable for the increased interest under section 6621(c).

Accordingly, respondent has the burden of proof on this issue. Rule 142(a).

Petitioner contests the increased interest under section 6621(c) on the ground that he intended to make a profit on the transactions. Petitioner admits that there was a valuation overstatement of more than 250 percent, see section 6621(c)(3)(A)(i), and we have concluded that the deductions and credit were not allowable because the transactions lacked economic substance and were tax motivated. Transactions which lack economic substance or business purpose are sham transactions under section 6621(c)(3)(A)(v). *McCrary v. Commissioner,* 92 T.C. 827, 857 (1989); *Patin v. Commissioner,* 88 T.C. 1086, 1128-1129 (1987), affd. sub nom. *Hatheway v. Commissioner,* 856 F.2d 186 (4th Cir. 1988), affd. sub nom. *Skeen v. Commissioner,* 864 F.2d 93 (9th Cir. 1989), affd. without published opinion 865 F.2d 1264 (5th Cir. 1989), affd. sub nom. *Gomberg v. Commissioner,* 868 F.2d 865 (6th Cir. 1989). Accordingly, respondent has met his burden of proof, and petitioner is liable for the increased interest under section 6621(c).

Decision will be entered for the respondent.

SUPREME COURT, U.S.
FILED
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No. 92-1069

In the Supreme Court of the United States

OCTOBER TERM, 1992

KERRY W. ILLES, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether petitioner was entitled to deduct as losses on transactions entered into for profit under Section 165(c) (2) of the Internal Revenue Code (26 U.S.C.) his out-of-pocket expenditures on master cassette recording transactions that admittedly lacked economic substance.

2. Whether petitioner was liable for the additions to tax for negligence and a substantial understatement of tax under Sections 6653(a) and 6661 of the Internal Revenue Code, as well as the increased rate of interest on an underpayment attributable to a tax motivated transaction under Section 6621(c), where he made no investigation of the venture or its promoter and sought no independent advice on the investment or its proper tax treatment.

3. Whether petitioner was liable for the addition to tax for a valuation overstatement under Section 6659 of the Internal Revenue Code, where his claimed deductions were disallowed on the ground that the transactions generating the deductions lacked economic substance.

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In the Supreme Court of the United States

OCTOBER TERM, 1992

No. 92-1069

KERRY W. ILLES, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-8a) is not yet reported. The memorandum opinion of the Tax Court (Pet. App. 13a-27a) is reported at 62 T.C.M. (CCH) 728.

JURISDICTION

The judgment of the court of appeals was entered on September 21, 1992. The petition for a writ of certiorari was filed on December 21, 1992 (a Monday). The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. In 1985, Thomas Graham solicited petitioner to participate in a master recording promotion entitled Children's Classics Audio Cassettes (CCAC) (Pet. App. 1a-2a). Petitioner agreed to invest in two CCAC master recording transactions in 1985 (*id.* at 2a, 18a-19a). From his aggregate cash outlay of $33,175, he expected to receive tax deductions totaling $144,400 and an investment tax credit of $6,000 (*id.* at 19a). The CCAC transactions were structured so that his expenditures would be paid by the potential tax savings (*id.* at 22a). Petitioner had no background in the record or cassette business. He made no effort to consult with anyone in the industry, to obtain appraisals or in any other manner to determine whether the venture had substance or commercial viability. He relied solely on information from the promoter (Graham) that identified the substantial tax benefits involved. Petitioner executed the CCAC documents without reviewing them (*id.* at 19a, 22a.).

On Graham's advice, petitioner claimed deductions totaling $61,775 and an investment tax credit of $5,473 with respect to his CCAC transactions on his 1985 return (Pet. App. 2a-3a). The Commissioner determined that petitioner was not entitled to the deductions and the credit because the CCAC transactions lacked economic substance. The Commissioner also determined additions to tax for negligence under Section 6653(a) of the Internal Revenue Code (26 U.S.C.), for a valuation overstatement under Section 6659, and for a substantial understatement of tax under Section 6661, as well as liability for the increased interest on an underpayment attributable to a tax motivated transaction pursuant to Section 6621(c) (Pet. App. 3a, 23a-27a).

2. Petitioner sought a redetermination of the deficiency and additions in the Tax Court. Petitioner

stipulated that his CCAC transactions lacked economic substance, that the CCAC assets were overvalued on his tax return by more than 250%, and that he was not entitled to the credits and deductions that he had claimed (Pet. App. 3a, 20a, 27a). He nevertheless asserted that he was entitled to deduct his out-of-pocket CCAC expenditures under Section 165(c)(2) as losses on a transaction entered into for profit (Pet. App. 3a, 20a).

The Tax Court rejected petitioner's argument, finding that he "had no profit motive other than for the tax benefits" (Pet. App. 22a). The court also held that, even if petitioner had a profit motive, he "could not prevail in this case because the transactions lacked economic substance" (*ibid.*).

The Tax Court also upheld the additions to tax determined by the Commissioner. The court found petitioner liable for negligence under Section 6653(a)[1] because there was no evidence of Graham's experience in the recording or cassette industries, or his knowledge of investment and tax matters (Pet. App. 24a-25a). Further, petitioner had made no attempt to verify Graham's credentials in either area (*ibid.*). The court concluded that "reasonable caution dictates that further inquiry be made to verify the accuracy of the tax and investment information received" and that petitioner would have sought independent advice "if he were truly concerned

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[1] Section 6653(a)(1) imposed an addition to tax equal to five percent of an underpayment if any part of the underpayment was due to negligence or disregard of rules or regulations. Section 6653(a)(2) imposed an addition to tax equal to 50% of the interest payable under Section 6601 on the portion of the underpayment attributable to negligence. 26 U.S.C. 6653(a)(2) (1982). Section 6653 was repealed by the Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7721(c)(1), 103 Stat. 2399. Provisions similar to Section 6653(a) are now found in Section 6662. See 26 U.S.C. 6662(b)(1) and (c) (Supp. II 1990).

about his investments, other than for the tax benefits" (*ibid.*).

In addition, the Tax Court concluded that petitioner was liable for the Section 6659 addition to tax due to his overstatement of the basis of the CCAC assets (Pet. App. 26a).[2] The court's determination that the CCAC transactions lacked economic substance included a finding that the CCAC property was overvalued (*id.* at 25a). The court concluded that petitioner's correct adjusted basis in the property was zero (*ibid.*). Because petitioner failed to show that he acted reasonably and in good faith in claiming the CCAC-related deductions, the Tax Court also rejected petitioner's argument that the Commissioner should have waived the substantial understatement penalty under Section 6661 (Pet. App. 26a).[3] Finally,

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[2] Section 6659 imposed an addition to tax of up to 30% of any underpayment of tax that was attributable to a valuation overstatement. 26 U.S.C. 6659. A "valuation overstatement" existed if the taxpayer reported on his tax return either a value or an adjusted basis for property that was 150% or more of the correct valuation or adjusted basis. 26 U.S.C. 6659(c). Section 6659 was repealed by the Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7721(c)(2), 103 Stat. 2399. Provisions similar to Section 6659 are now found in Section 6662, relating to substantial valuation misstatements. 26 U.S.C. 6662(b)(3) and (e) (Supp. II 1990).

[3] Section 6661 imposed an addition to tax on that portion of an underpayment that is a "substantial understatement." 26 U.S.C. 6661(a). For individual taxpayers, an understatement was substantial if it exceeded $5,000 or 10% of the tax for that taxable year. 26 U.S.C. 6661(b)(1)(A). The substantial understatement penalty could be waived if the taxpayer showed that there was reasonable cause for the understatement and that he or she acted in good faith. 26 U.S.C. 6661(c). Section 6661 was repealed by the Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7721(c)(2), 103 Stat. 2399. Provisions similar to Section 6661 are now found in Section 6662. See 26 U.S.C. 6662(b)(2) and (d) (Supp. II 1990).

the court held that when, as here, assets are overvalued by more than 250% and transactions are shams lacking economic substance, the increased interest under Section 6621(c) properly is imposed (Pet. App. 27a).[4]

3. The court of appeals affirmed (Pet. App. 3a-8a). Citing *Rose* v. *Commissioner*, 868 F.2d 851, 853 (6th Cir. 1989), and *Mahoney* v. *Commissioner*, 808 F.2d 1219, 1220 (6th Cir. 1987), the court stated that, once it is determined that a transaction lacks economic substance, a secondary inquiry into whether the taxpayer was motivated by profit to participate in the transaction "is never made" (Pet. App. 3a). The court therefore held that petitioner was not entitled to a loss deduction "regardless of whether [he] was actually, honestly, and exclusively motivated by profit" (*id.* at 4a). The court sustained, as not clearly erroneous, the Tax Court's finding that petitioner was negligent for purposes of Section 6653(a) because a reasonable person who knew that Graham had a personal stake in the CCAC venture would not have committed nearly $150,000 to the program without independent investigation and independent advice (Pet. App. 5a). Rejecting petitioner's contention that Section 6659 is inapplicable to underpayments in tax that result from transactions found to lack economic substance, the court concluded that "[t]he entire artifice of the CCAC shelter was constructed on the foundation of the overvaluation of

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[4] Section 6621(c) provided for 120% of the normal interest rate on substantial underpayments of tax attributable to "tax motivated transactions." An underpayment was substantial if it exceeded $1,000 (26 U.S.C. 6621(c)(2)), and a "tax motivated transaction" was defined to include, inter alia, "any valuation overstatement (within the meaning of section 6659(c))" and "any sham or fraudulent transaction" (26 U.S.C. 6621(c)(3)(A)(i) and (v)). Section 6621(c) was repealed for tax returns due after December 31, 1989, by the Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7721(b) and (d), 103 Stat. 2399, 2400.

its assets. Plainly, then, [petitioner's] underpayment was attributable to his valuation overstatement" (Pet. App. 6a). The court further concluded that petitioner's argument that the Commissioner should have waived the Section 6661 addition to tax was "unavailing" because he failed to show that he reasonably relied on Graham's advice (Pet. App. 8a). Finally, because petitioner admitted that Section 6621(c) would be applicable if either the valuation overstatement penalty or the finding that he had not acted reasonably was affirmed, the court upheld the Tax Court's determination that petitioner was liable for the increased rate of interest under Section 6621(c) (Pet. App. 8a).

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or of any other court of appeals. Further review is therefore not warranted.

1. The court of appeals correctly affirmed the Tax Court's conclusion that petitioner was not entitled to a loss deduction under Section 165 of the Internal Revenue Code on his investment in a tax shelter that lacked economic substance.[5] Once it has been determined that a transaction has no economic substance other than tax benefits, the transaction is disregarded for federal tax purposes. *Knetsch* v. *United States*, 364 U.S. 361, 366 (1960). Losses arising from a transaction that lacks economic substance are therefore not allowed as deductions under Section 165. Since petitioner admitted that his CCAC transactions lacked economic substance, the court was not required to conduct a further inquiry into

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[5] Under Section 165, an individual is allowed "a deduction [for] any loss sustained during the taxable year and not compensated for by insurance or otherwise," if incurred in "[a] transaction entered into for profit." 26 U.S.C. 165(a) and (c)(2).

whether he was motivated by profit to participate in the venture (Pet. App. 3a). That conclusion comports with the decisions of other courts of appeals that losses arising from a transaction that lacks economic substance are not allowed as deductions under Section 165, regardless of the taxpayer's purported profit motive. See *Shriver* v. *Commissioner*, 899 F.2d 724, 727 (8th Cir. 1990); *Dewees* v. *Commissioner*, 870 F.2d 21, 29 (1st Cir. 1989); *Kirchman* v. *Commissioner*, 862 F.2d 1486, 1493 (11th Cir. 1989).

Petitioner errs in contending (Pet. 9-10) that the decision in this case conflicts with the decisions of the Second Circuit in *Jacobson* v. *Commissioner*, 915 F.2d 832 (1990), and the Tenth Circuit in *Miller* v. *Commissioner*, 836 F.2d 1274 (1988). Neither of those cases involved a situation where, as here, the taxpayer admitted that the subject transactions lacked economic substance. Nor do those cases hold that deductions from transactions that lack economic substance are allowable if the taxpayer had a profit motive. In *Jacobson*, the question was whether the Tax Court correctly determined that the transaction at issue was "devoid of economic substance" (915 F.2d at 837). The Second Circuit held in that case that the Tax Court could not base its conclusion that the film venture lacked economic substance solely on its subjective conclusion that the film was so bad that it could never realize a profit (*id.* at 839). In *Miller*, the Commissioner disallowed losses arising from commodities straddles solely on the ground that the transactions were not entered into primarily for profit (836 F.2d at 1277), and the Tenth Circuit addressed only that issue. There is thus no authority for petitioner's claim (Pet. 9) that the court of appeals should have applied a "facts and circumstances" test to determine his profit motive.

Since his transactions lacked economic substance, his purported profit motive was irrelevant.[6]

2. The court of appeals correctly affirmed (Pet. App. 5a, 7a-8a) the Tax Court's determinations (*id.* at 24a, 26a-27a) that petitioner was liable for the additions to tax for negligence under Section 6653(a) and a substantial understatement under Section 6661, as well as the increased rate of interest on a substantial underpayment of tax attributable to a tax-motivated transaction under Section 6621(c).

For purposes of Section 6653(a), negligence is a lack of due care or the failure to do what a reasonably prudent person would do under the circumstances. *Neeley* v. *United States*, 775 F.2d 1092, 1095 (9th Cir. 1985). The Commissioner has discretion to waive the substantial understatement penalty "on a showing by the taxpayer that there was reasonable cause for the understatement * * * and that the taxpayer acted in good faith." 26 U.S.C. 6661(c). See *Heasley* v. *Commissioner*, 902 F.2d 380, 384 (5th Cir. 1990); *Mailman* v. *Commissioner*, 91 T.C. 1079, 1082-1084 (1988); Treas. Reg. § 1.6661-6(b). Petitioner contends (Pet. 12, 16, 17) that he should not be liable for these penalties because he reasonably relied on the advice of Graham, the promoter of the CCAC tax shelter. Those contentions are without merit.

The Tax Court correctly found that petitioner entered into his CCAC transactions with "no profit motive other than for the tax benefits" (Pet. App. 22a). No reasonable person interested in making an investment for profit would commit $150,000 solely on the advice of the promoter of a tax shelter without even a minimal investiga-

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[6] Even if petitioner's profit motive were relevant, the Tax Court found that petitioner "did not have an actual and honest objective of making a profit, but entered into the transactions for the sole purpose of obtaining income tax benefits" (Pet. App. 22a). That fact-bound conclusion does not warrant further review.

tion into the venture or into the promoter's knowledge of, or credentials in, the relevant industry (*id.* at 5a, 24a-25a). Moreover, petitioner made no attempt to verify the promoter's tax advice with an independent and qualified tax advisor or to determine whether Graham had any knowledge in investment or tax matters (*id.* at 20a).

Petitioner is mistaken in asserting (Pet. 15-16) that the decision of the court of appeals with respect to the Section 6661 penalty is contrary to the decision of the Fifth Circuit in *Heasley* and the decision of the Ninth Circuit in *Vorsheck* v. *Commissioner*, 933 F.2d 757, cert. denied, 112 S. Ct. 591 (1991). The taxpayers in those cases, unlike petitioner, obtained independent advice as to the tax consequences of their transactions. The taxpayers in *Heasley* read the prospectus for the venture and discussed the program in detail with both the promoter and an independent accountant before deciding to invest. 902 F.2d at 381. The taxpayers in *Heasley* also obtained advice from an outside accountant as to how to report the transaction on their tax returns and monitored the venture. 902 F.2d at 381, 384. Similarly, in *Vorsheck*, the taxpayers relied "upon the advice of their trusted tax advisor" (933 F.2d at 759). By contrast, as the court of appeals observed in the present case, petitioner "sought [no] independent professional advice on the validity and viability of the investments," and his asserted reliance on Graham cannot "be viewed as reasonable, since Graham was not a disinterested source" (Pet. App. 6a).[7]

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[7] Petitioner errs in contending (Pet. 12) that the decision in this case conflicts with this Court's decision in *United States* v. *Boyle*, 469 U.S. 241 (1985). In considering whether a taxpayer had reasonable cause for failing timely to file his tax return, the Court stated in *Boyle* that it is reasonable for a taxpayer to rely on the advice of an accountant or attorney. *Id.* at 251. The decision in *Boyle* in no way suggests that a taxpayer may be excused from

Even if petitioner's contention of reasonable reliance were accepted, it would not relieve him of liability for the increased interest rate under Section 6621(c). The critical inquiry under Section 6621(c) is whether an underpayment is "attributable to tax motivated transactions"; if so, the increased rate "shall" be imposed. 26 U.S.C. 6621(c)(1). A "tax motivated transaction" includes a valuation overstatement as defined in Section 6659 (26 U.S.C. 6621(c)(3)(A)(i)) and a sham transaction lacking economic substance (26 U.S.C. 6621(c)(3)(A)(v)). See *Kennedy* v. *Commissioner*, 876 F.2d 1251, 1256 (6th Cir. 1989); *Skeen* v. *Commissioner*, 864 F.2d 93, 96 (9th Cir. 1989)). Unlike Sections 6653 and 6661, and contrary to petitioner's assertion (Pet. 17-18), there is no provision in Section 6621(c) for avoiding the increased interest rate because of reasonableness or good faith and the Fifth Circuit did not draw such a conclusion in *Heasley*. Instead, the court found the increased interest rate inapplicable in *Heasley* because the subject transaction was profit-motivated, not tax-motivated (902 F.2d at 386), and the taxpayers' understatement was "not attributable to a valuation overstatement" (902 F.2d at 385). Neither of those circumstances is present here.

3. The court of appeals correctly held (Pet. App. 6a-7a) that imposition of the addition to tax for a valuation overstatement under Section 6659 is appropriate when, as here, deductions are disallowed on the specific ground that the transactions generating the deductions lack economic substance. See *Gilman* v. *Commissioner*, 933

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additions to tax based on reliance on the advice of the promoter of a tax shelter, as opposed to that of an independent attorney or accountant. See *Coleman* v. *Commissioner*, 60 T.C.M. (CCH) 889, 891 (1990) (requiring a taxpayer to seek tax advice independent from the promoter of a tax shelter "is not equivalent to requiring him to seek a 'second opinion,' rather, it is merely requiring him to seek 'advice' for the *first* time").

F.2d 143, 150-152 (2d Cir. 1991), cert. denied, 112 S. Ct. 871 (1992); *Massengill* v. *Commissioner*, 876 F.2d 616, 619-620 (8th Cir. 1989); *Rybak* v. *Commissioner*, 91 T.C. 524, 566-567 (1988); *Clayden* v. *Commissioner*, 90 T.C. 656, 677-678 (1988). Contrary to petitioner's contention (Pet. 13-14), this holding does not conflict with the decisions of the Fifth Circuit in *Heasley* and *Todd* v. *Commissioner*, 862 F.2d 540 (1988), or with the decision of the Ninth Circuit in *Gainer* v. *Commissioner*, 893 F.2d 225 (1990). Those cases did not involve the disallowance of deductions from a transaction that lacked economic substance. Moreover, those courts did not find that "[t]he tax benefit generated by the * * * shelter was directly dependent upon the valuation over-statement" such that the "underpayment was attributable to [the] overstatement" (Pet. App. 6a).

In both *Todd* and *Gainer*, depreciation deductions were disallowed because the property in issue had not been "placed in service" during the taxable year. In such circumstances, the Fifth Circuit held (862 F.2d at 543), and the Ninth Circuit agreed (893 F.2d at 228-229), that the taxpayers' valuation of the property had "no impact whatsoever on the amount of tax [liability] actually owed" (862 F.2d at 543). The unique facts presented in *Todd* and *Gainer* are not present here. Petitioner stipulated that he overvalued the CCAC property by more than 250% (Pet. App. 27a). Since this overvaluation resulted in improper deductions, the overvaluation penalty properly was assessed. As the court of appeals observed (*id.* at 7a), "[h]ad it not been for the valuation overstatement, [petitioner] would not have underpaid his taxes." Thus, the court's analysis is consistent with *Todd* and *Gainer*, not in conflict with them.

In *Heasley*, the Commissioner determined tax deficiencies on a number of alternative grounds, "including, among others, that petitioners did not have a profit

objective, that the EMS units were not qualifying property, *that they were not placed in service*, and that the units were overvalued." *Heasley* v. *Commissioner*, 55 T.C.M. (CCH) 1748, 1754 (1988) (emphasis added). In the Tax Court, the taxpayers conceded that they were not entitled to the investment tax credits they had claimed, without stating any specific basis for their concession. They argued that, since they had conceded the deficiencies, "it is impossible to determine the reason for any understatement" (*ibid.*) and for that reason they were not liable for the addition to tax under Section 6659. The Fifth Circuit concluded that, when a deduction or credit is disallowed in its entirety, the underpayment is not attributable to the valuation overstatement, but rather "is attributable to claiming an improper deduction or credit." 902 F.2d at 383. Although that language is broad, *Heasley* did not involve a situation in which deductions were disallowed for the specific reason that the transaction lacked economic substance. The Fifth Circuit has not directly addressed the question whether application of Section 6659 would be proper in that circumstance. It therefore cannot be said that *Heasley* conflicts with the decision in this case.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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